



*Mismatched Names and Identification  
Numbers on Information Documents Could  
Undermine Strategies for Reducing  
the Tax Gap*

**August 31, 2007**

**Reference Number: 2007-30-159**

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.

**Redaction Legend:**

1 = Tax Return/Return Information

2(e) = Law Enforcement Procedure(s)

2(f) = Risk Circumvention of Agency Regulation or Statute (whichever is applicable)

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TREASURY INSPECTOR GENERAL  
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

August 31, 2007

**MEMORANDUM FOR** COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED  
DIVISION

*Michael R. Phillips*

**FROM:**

Michael R. Phillips  
Deputy Inspector General for Audit

**SUBJECT:**

Final Audit Report – Mismatched Names and Identification Numbers  
on Information Documents Could Undermine Strategies for Reducing  
the Tax Gap (Audit # 200630IE002)

This report presents the results of our review to evaluate the progress of efforts to minimize the volume of mismatched names and identification numbers reported on the Miscellaneous Income (Form 1099-MISC) and the Wage and Tax Statement (Form W-2) (hereafter referred to as miscellaneous income and wage statements, respectively).

*Impact on the Taxpayer*

The Internal Revenue Service (IRS) annually receives millions of miscellaneous income and wage statements with mismatched names and identification numbers that it is unable to use in determining if the recipients filed tax returns and/or reported the income reflected on the statements. These mismatches consequently create opportunities for the income recipients to avoid the scrutiny of the IRS through underreporting income and not filing tax returns. Those recipients that take advantage of such opportunities can create unfair burdens on honest taxpayers and diminish the public's respect for the tax system.

*Synopsis*

Accurate information reporting is central to the success of the nation's voluntary tax system because it assists taxpayers in filing correct tax returns, maintains high levels of compliance, and allows the IRS to more economically and efficiently detect and pursue noncompliant taxpayers who underreport income or do not file tax returns. Because of the benefits involved, we and others support the enhancement and expansion of information reporting as a key strategy to



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reduce the underreporting of taxes that in part gives rise to the estimated \$345 billion tax gap (the difference between what is paid in taxes and what should be paid according to the tax laws). However, mismatched names and identification numbers on information documents could undermine the effectiveness of the strategy because the success of information reporting is largely dependent upon the accuracy of the names and identification numbers reported on the documents.

For Tax Years (TY) 2001 through 2004, the IRS received about 48 million miscellaneous income and wage statements (reporting \$931 billion of income) that it was unable to use in determining if the recipients filed tax returns and reported the income. The majority of the income involved nonemployee (e.g., independent contractor) compensation reported on unusable miscellaneous income statements. In TY 2004 alone, the IRS received about 3.8 million miscellaneous income statements (reporting approximately \$150 billion in earnings) that could not be computer matched to a filed tax return because of missing or erroneous identification numbers. Compared to when we first reported the problem in 2001,<sup>1</sup> this is a 63 percent increase in the number of unusable documents reporting nonemployee compensation, and the earnings reported on the documents have more than doubled.

The President's Fiscal Year 2008 budget recommends legislation that requires businesses to verify the accuracy of identification numbers for the independent contractors they hire and to withhold taxes from those whose identification numbers do not match IRS records. These proposals reiterate recommendations that we, the IRS, and the Government Accountability Office have made to address the root causes that largely account for the low compliance levels among independent contractors and the number of miscellaneous income statements submitted with mismatched names and identification numbers. A similar legislative solution is needed to address the problem with mismatched names and identification numbers on wage statements.

Because the Fiscal Year 2008 budget involves just legislative proposals, we believe the IRS needs to thoroughly consider other options, including additional research to resolve more incorrect identification numbers. We used IRS automated data systems to manually research statistically valid samples of 374 miscellaneous income statements and 246 wage statements from TY 2004 with mismatched names and identification numbers reporting more than \$60,000 in earnings.<sup>2</sup> We successfully validated 309 (50 percent) of the 620 statements and matched them to taxpayer accounts in IRS records.

When projected to the populations, our sample results indicate 6,042 individuals had not filed TY 2004 returns, although the statements reported they had earned, on average, about \$104,327. Some individuals had not filed tax returns for several years, and the mismatched documents

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<sup>1</sup> *Significant Tax Revenue May Be Lost Due to Inaccurate Reporting of Taxpayer Identification Numbers for Independent Contractors* (Reference Number 2001-30-132, dated August 2001).

<sup>2</sup> We selected statements reporting more than \$60,000 in earnings because it would enable us to focus our efforts on those with the highest amount of unreported income.



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showed their earnings exceeded \$200,000 in 1 or more of the years. Altogether, we estimate there could be \$630 million in earnings not reported by 6,042 individuals who may not have filed their tax returns.

### *Recommendations*

We recommended the Director, Examination, Small Business/Self-Employed Division, forward the observations in this report to the Department of the Treasury to use in assessing the need for tax law changes that would allow the IRS to verify employee identification numbers for employers and require employers to (1) use the IRS identification number matching system to verify the accuracy of identification numbers for the employees they hire and (2) withhold taxes at the maximum rates on those whose identification numbers do not match IRS records. We also recommended the Director use IRS automated data systems to research, resolve, and investigate high-dollar miscellaneous income and wage statements with mismatched names and identification numbers.

### *Response*

IRS management agreed with our first recommendation; however, they do not plan to take any action on the second recommendation. In deciding not to take action, IRS management noted that, among other things, the additional cost of manually perfecting mismatched names and identification numbers on miscellaneous income and wage statements may exceed the monetary benefits. Management's complete response to the draft report is included as Appendix VI.

### *Office of Audit Comment*

The IRS decision not to act on our second recommendation based on a cost/benefit concern is puzzling because we estimate the benefit of \$233.36 million in additional revenue exceeds by a large margin the costs the IRS would incur. In Fiscal Year 2007, for example, the IRS paid its most experienced examiners working in the highest cost of living area in the country about \$62 an hour in salary and benefits. IRS records show the examiners produced about \$354 for each hour they spent examining a tax return (a net return of about \$292 an hour). In comparison, we estimate that, if instead of examining tax returns the examiners had perfected and investigated the 103,471 mismatched documents reflected in Figure 3 of the report, they would have generated an average of about \$2,255 per hour (a net return of about \$2,193 an hour).

Copies of this report are also being sent to IRS managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Daniel R. Devlin, Assistant Inspector General for Audit (Small Business and Corporate Programs), at (202)-622-5894.



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*Abbreviations*

GAO	Government Accountability Office
IRS	Internal Revenue Service
SSN	Social Security Number
TY	Tax Year



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## *Mismatched Names and Identification Numbers on Information Documents Could Undermine Strategies for Reducing the Tax Gap*

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### *Background*

Shortly after the end of each calendar year, billions of information documents are prepared and used to report a variety of transactions and payments to the Internal Revenue Service (IRS). Two of the more commonly used information documents are the Miscellaneous Income (Form 1099-MISC) and the Wage and Tax Statement (Form W-2) (hereafter referred to as miscellaneous income and wage statements, respectively).

In general, the tax laws<sup>1</sup> require those engaged in a trade or business to annually file accurate miscellaneous income statements to report payments for services of \$600 or more made to individuals who are not their employees (e.g. independent contractors). Similarly, employers are required to annually prepare and file accurate wage statements to report the amount of earnings paid to, and the taxes withheld from, their employees.

Both miscellaneous income and wage statements are used by the IRS in computer matching routines to determine whether the respective independent contractors and employees filed their income tax returns and accurately reported the earnings. However, before the IRS can make this determination,

***Miscellaneous income and wage statements are used by the IRS to determine whether independent contractors and employees filed income tax returns and accurately reported their earnings.***

it must validate the accuracy of the names and identification numbers reported on the documents to its records and those of the Social Security Administration. For most individuals, the identification number is the Social Security Number (SSN) that was issued by the Social Security Administration. The IRS additionally issues as identification numbers nine-digit Employer Identification Numbers and Individual Taxpayer Identification Numbers. Employer Identification Numbers are generally assigned to businesses, such as sole proprietors<sup>2</sup> and corporations; Individual Taxpayer Identification Numbers are assigned to individuals who do not have, and are not eligible to obtain, an SSN.

To encourage the filing of miscellaneous income and wage statements with accurate identification numbers, Congress has placed in the tax laws numerous provisions that give the IRS the authority to assess penalties against those who file incomplete or inaccurate information documents. The IRS is also authorized to require businesses that hire independent contractors to

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<sup>1</sup> 26 U.S.C. Section (§) 6041(a) (2007).

<sup>2</sup> Sole proprietors are self-employed individuals who generally file a U.S. Individual Income Tax Return (Form 1040) Profit or Loss From Business (Schedule C) with their Forms 1040 to report the income and expenses from their businesses. They are involved in a variety of businesses that provide goods and services, such as retailers, manufacturers, professionals, and home-repair contractors.



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begin backup withholding of taxes,<sup>3</sup> at the rate of 28 percent of the earnings, from any independent contractor that fails to provide them with an identification number or with one that is accurate.

This review was performed in the IRS Small Business/Self-Employed Division Headquarters in New Carrollton, Maryland, during the period July 2006 through February 2007. Due to time and resource constraints, we did not audit IRS databases to validate the accuracy and reliability of their information. Also, we did not evaluate the adequacy of IRS internal controls over miscellaneous income and wage statements because that was outside the scope of the review. Otherwise, the audit was conducted in accordance with *Government Auditing Standards*. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

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<sup>3</sup> Backup withholding of taxes is an IRS procedure designed to ensure some taxes are paid on earnings.





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*Results of Review*

***Information Reporting Is Central to the Success of Our Nation's Voluntary Tax System and Reducing the Tax Gap***

The role and benefits of third-party information reporting are central to the success of our nation's tax system because they help assure taxpayers accurately report their income and certain deductions. Under the tax laws, information reporting generally is required to take place shortly after the end of the calendar year so taxpayers can receive and use the information in preparing their annual tax returns. This process reduces the likelihood that taxpayers may inadvertently neglect to include items such as wages they earned from a part-time job held for a short period of time or the interest income from a small savings account. Moreover, experience indicates that information reporting maintains high levels of compliance. For example, the IRS and others have reported that, over time, individuals have voluntarily reported 99 percent of the income reported on wage statements. In contrast, individuals who did not receive such information documents voluntarily reported only about 83 percent of their income.

Besides assisting taxpayers and maintaining high levels of compliance, information reporting is a key component in IRS compliance programs that are designed to detect and pursue noncompliant taxpayers who underreport income and/or do not file tax returns. In the Information Returns Program, IRS computers match the income reflected on the information documents submitted by third parties to the income on the filed tax returns of those who receive the

***Besides maintaining high levels of compliance over time, computer matching of information reporting is a key component of the IRS' efforts to detect and pursue those who underreport income or do not file tax returns.***

documents. If the match shows a discrepancy between income amounts, a potential underreporter case may be developed so the IRS can determine whether further investigation is warranted to resolve potential unreported income. For a match that shows income but no corresponding tax return, a potential nonfiler case is initiated.

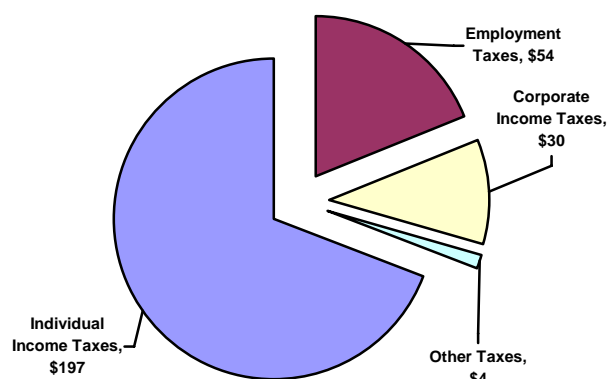
As a result of the matching, the IRS annually contacts about 3 million taxpayers regarding potential discrepancies in their tax information; another 2 million taxpayers are contacted to resolve potential nonfiler situations. According to 2005 IRS statistics, the contacts resulted in tax, interest, and penalty assessments of about \$4 billion against taxpayers who had filed their tax returns but underreported their income. The IRS additionally reported making another \$8 billion in assessments against taxpayers who had not filed their tax returns.



## *Mismatched Names and Identification Numbers on Information Documents Could Undermine Strategies for Reducing the Tax Gap*

Because of the success the IRS achieves through computer matching, many<sup>4</sup> are calling for the enhancement and expansion of information reporting, particularly for independent contractors, to reduce the underreporting of taxes that in part gives rise to the estimated \$345 billion tax gap (the difference between what is paid in taxes and what should be paid according to the tax laws).

**Figure 1: The IRS' Tax Year 2001 Underreporting Gross Tax Gap Estimates**



Source: Our analysis of data from the Department of the Treasury's strategy for reducing the tax gap. Amounts shown are in billions.

Using compliance data it collected from Tax Year (TY) 2001, the IRS estimates that underreporting accounts for about 83 percent of the tax gap (\$285 billion of the \$345 billion). As shown in Figure 1, the IRS attributes most (69 percent) of the underreporting to individuals (approximately \$197 billion of \$285 billion). Within the individual estimate, the IRS believes most (about \$109 billion) of the underreporting involves business income from self-employed individuals, including independent contractors.

Because independent contractors are generally assessed income and self-employment taxes on the same

earnings, those who underreport their income also underreport the amount of self-employment taxes they owe. As a result, a significant portion of the tax gap associated with both underreported income and underreported self-employment taxes involves independent contractors.

### **The success of using information documents to improve compliance and reduce the tax gap depends on the IRS receiving accurate names and identification numbers on miscellaneous income and wage income statements**

The ability of the IRS to successfully use computer matching in determining if income is reported and tax returns are filed is largely dependent upon the accuracy of the names and identification numbers reported on submitted miscellaneous income and wage statements. Given the central role this has in tax administration, it is not surprising that numerous studies have been conducted on how to better ensure accurate names and identification numbers are submitted on the statements.

<sup>4</sup> Those calling for strengthening information reporting for independent contractors include us, the Government Accountability Office, the IRS, and the Department of the Treasury.



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Several studies, including those that we, the IRS, and the Government Accountability Office (GAO) have completed, suggested legislative or regulatory changes are needed that would hold businesses more accountable for obtaining accurate identification numbers from the employees and independent contractors they hire. Although penalty provisions in the tax laws are intended to address this issue, they have been used sparingly and have been largely ineffective.

In 2001, for example, we reported on the growing problem with miscellaneous income statements reporting the earnings of independent contractors with erroneous identification numbers.<sup>5</sup> We found, among other things, that for TYs 1996 and 1997 penalties were assessed against only 3,356 (0.2 percent) of the approximately 1,643,000 businesses who had submitted miscellaneous income statements with missing or inaccurate identification numbers. Our recommendations were predicated on the implementation of an identification number verification system and included (1) requiring businesses to use the system in verifying the accuracy of identification numbers at the beginning of their relationships with workers and (2) imposing backup withholding taxes on those workers who provide inaccurate identification numbers.

The IRS reported in April 2003 that, although 50 employers included in its study filed large numbers of wage statements with inaccurate SSNs, all met the reasonable cause standards in the tax laws for waiving penalties.<sup>6</sup> The report recommended numerous legislative and regulatory changes that could be made to increase the accuracy of identification numbers on wage statements; several of them would require employers to take greater responsibility for ensuring the accuracy of the identification numbers. Among the recommendations cited in the report is a requirement for employers to verify the accuracy of identification numbers for all new employees and to withhold taxes at the highest rate for those who provide an inaccurate identification number.

As recently as 2004, the GAO highlighted the need for regulatory changes when it reported that employers need to be more accountable for increasing the accuracy of identification numbers on wage statements.<sup>7</sup> According to the GAO:

*Because little or no likelihood exists for penalties to be levied, the potential of the statutory penalty tool to encourage greater accuracy of wage statements is compromised. Further, because employers have no responsibility to verify SSNs, opportunities to detect and correct SSN inaccuracies before [the] SSA [Social Security Administration] and IRS need to react to them and possibly consider penalizing employers are lost. Accordingly, thoroughly exploring options to change the reasonable cause standard, including possibly requiring that employers take steps*

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<sup>5</sup> *Significant Tax Revenue May Be Lost Due to Inaccurate Reporting of Taxpayer Identification Numbers for Independent Contractors* (Reference Number 2001-30-132, dated August 2001).

<sup>6</sup> The IRS' Large and Mid-Size Division: *The Form W-2 SSN/Name Mismatch Project*, dated April 2003.

<sup>7</sup> TAX ADMINISTRATION: *IRS Needs to Consider Options for Revising Regulations to Increase the Accuracy of Social Security Numbers on Wage Statements* (GAO-04-712, dated August 2004).



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*to verify the accuracy of SSNs provided by employees, must be a critical part of [the] IRS's consideration of how to make their penalty program more effective.*

Despite the focus on information reporting and the central role many are expecting it to have in closing the tax gap, reducing the number of mismatched names and identification numbers on miscellaneous income and wage statements remains a significant challenge.

### ***Statutory Constraints Are Hampering the Progress That Could Be Made to Increase the Accuracy of Information Reported on Miscellaneous Income and Wage Statements***

Mismatched names and identification numbers on information documents can occur for a variety of reasons. For example, a worker could inadvertently provide an employer with a wrong identification number, or an employer could make an error when recording an otherwise valid identification number on a document. We believe it is also reasonable to assume that some workers who may want to hide their identities and underreport their income or not file tax returns would provide incorrect identification numbers to those that hire them.

For TYs 2001 through 2004, the IRS received about 48 million miscellaneous income and wage statements (reporting \$913 billion of income) that it was unable to use in determining if the recipients filed tax returns and/or reported the income. The majority of the income involved nonemployee (e.g., independent contractor) compensation reported on unusable miscellaneous income statements. In TY 2004 alone, the IRS received about 3.8 million miscellaneous income statements (reporting approximately \$150 billion in earnings) that could not be computer matched to a filed tax return because of missing or erroneous identification numbers. These mismatches consequently create opportunities for the income recipients to avoid the scrutiny of the IRS through underreporting income and not filing tax returns. We believe those recipients that take advantage of such opportunities create unfair burdens on honest taxpayers and diminish the public's respect for the tax system. Moreover, compared to when we first reported the problem in 2001, there has been a 63 percent increase in the number of unusable documents reporting nonemployee compensation, and the earnings reported on the documents have more than doubled.

The increase in the number of unusable miscellaneous income statements and the relatively flat trend in the number of unusable wage statements are, according to the IRS, reflective of the overall trends in the universe of miscellaneous income and wage statements filed over the past few decades. One of the primary factors driving the trends is the outsourcing of work to independent contractors. Businesses started noticeably outsourcing work to independent contractors beginning in the 1980s and are continuing this practice today as a way to save on employee-related expenses such as payroll taxes, health care costs, and retirement plans. From a business perspective, hiring independent contractors instead of increasing payroll and other costs by adding employees may make sense as a cost-saving measure. However, it raises concerns



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from a tax compliance perspective because, unlike employees, independent contractors usually have no taxes withheld from their earnings.

### **The absence of a requirement to withhold taxes from independent contractors poses a significant challenge to tax administration**

By law, employers are required to systematically withhold income, Social Security, and Medicare taxes from the compensation paid to their employees and remit the withheld taxes to the IRS. Employers are also responsible for paying unemployment taxes and a share of each employee's Social Security and Medicare taxes. They may also pay for health care coverage and other fringe benefits. The systematic withholding and reporting of taxes by employers, assuming employees have given them correct identification numbers, is a reason often cited for the near-perfect compliance among wage earners.

In contrast to wage earners, for whom taxes are collected primarily through withholding requirements, the same taxes owed by independent contractors are collected mainly through a self-assessment process. Businesses have no requirement to withhold taxes from the compensation paid to independent contractors, nor do they have any reporting obligations to the IRS if the payments to an individual total less than \$600 in any given year. Instead, independent contractors bear full responsibility for estimating, setting aside, reporting, and paying the income, Social Security, and Medicare taxes they determine are due from their earnings.

***Independent contractors are responsible for estimating, setting aside, reporting, and paying the taxes they determine are owed.***

While IRS statistics indicate the vast majority of independent contractors comply with the tax laws, the absence of withholding and full information reporting creates opportunities to underreport income on tax returns and avoid detection by the IRS. Some individuals are clearly taking advantage of these opportunities, given the significant amount of evidence presented over the years showing independent contractors tend to have significantly lower levels of compliance than employees.

An IRS study, for example, showed as early as 1974 that independent contractors voluntarily reported only 74 percent of their income. The IRS subsequently estimated that the 1992 tax gap caused by independent contractors who did not report their income exceeded \$30 billion. Additionally, the GAO, Joint Committee on Taxation, and Office of Tax Policy in the Department of the Treasury all acknowledged the revenue loss associated with the lower compliance rates of independent contractors.





## *Mismatched Names and Identification Numbers on Information Documents Could Undermine Strategies for Reducing the Tax Gap*

### **The IRS may never significantly reduce the number of miscellaneous income and wage statements with mismatched names and identification numbers without legislative changes**

Our reports and those of the GAO have long called for legislative changes to address fundamental and systemic problems associated with inaccurate identification numbers on miscellaneous income and wage statements. We are encouraged that the President's Fiscal Year 2008 budget recommends legislation that requires businesses to verify the accuracy of identification numbers for the independent contractors they hire and to withhold taxes from those whose identification numbers do not match IRS records. These proposals reiterate recommendations that we, the IRS, and the GAO have made to address the root causes that largely account for the low compliance levels among independent contractors and the number of miscellaneous income statements submitted with mismatched names and identification numbers. Figure 2 highlights the various components of the proposal and shows that the Department of the Treasury Office of Tax Policy estimates the change could generate \$749 million in tax revenues over a 9-year period.

**Figure 2: Revenue Proposal to Improve Independent Contractor Compliance**

Key Components	Potential Benefits
Businesses required to verify the accuracy of the independent contractor's identification number.	Enhances compliance by increasing the accuracy of information reporting.
Businesses required to withhold taxes from an independent contractor who submits an inaccurate identification number.	Assures some taxes are collected from those who may otherwise escape paying any taxes.
Independent contractor could opt to have businesses withhold taxes.	Reduces the burden of having to estimate and set aside tax payments.
Proposal effective for payments totaling more than \$600 made in the course of business after January 1, 2008.	Will generate about \$749 million in tax revenue over 9 years, according to the Office of Tax Policy.

*Source: Our analysis of a revenue proposal in the President's Fiscal Year 2008 budget.*

While the proposal has the potential to significantly improve compliance and deliver other, more modest benefits, such as reducing the burden of having to estimate and set aside tax payments, a similar legislative solution is needed to address inaccurate identification numbers on wage statements. Moreover, because there is no guarantee proposed legislation will be enacted into law, the IRS needs to thoroughly consider other options to offset this risk, including additional research to resolve more incorrect identification numbers.



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## *Mismatched Names and Identification Numbers on Information Documents Could Undermine Strategies for Reducing the Tax Gap*

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### **Privacy provisions in the tax laws need to be addressed before employers can verify the accuracy of identification numbers for employees they hire**<sup>8</sup>

Without a legislative change to allow employers to take advantage of the investment that has been made in the IRS Internet-based identification number matching system, the volume of inaccurate identification numbers on wage statements may never be significantly reduced. Introduced in 2003, the system can instantaneously verify up to 25 identification number and name combinations in IRS records; larger requests can be sent to the IRS electronically and a response can be received within 1 business day. Although employer groups, such as the National Association for Self-Employed,<sup>9</sup> would likely welcome the opportunity to use the IRS Internet-based identification number matching system in verifying the accuracy of the names and identification numbers of the workers they hire, a significant barrier needs to be addressed. Specifically, privacy provisions in the tax laws that allow the IRS to verify independent contractors' identification numbers for businesses do not extend to wage earners.

Although, in a previous session of Congress, legislation was passed that would have removed this barrier, the Congressional term expired before the legislation became law.<sup>10</sup> Accordingly, we believe followup legislation needs to be submitted to Congress for consideration that would allow the IRS to verify employee identification numbers for employers. To take full advantage of the investment made in the IRS identification number matching system, the proposed legislation needs to additionally require that employers use the system in verifying the accuracy of the identification numbers for the employees they hire and to withhold taxes at the maximum rate on those whose identification numbers do not match IRS records.

While the legislative changes discussed offer the greatest potential for resolving the fundamental and systemic problems associated with inaccurate identification numbers, considerable time will likely lapse before they become law and the processes are in place to administer them. Further, there is no guarantee the proposed changes will be enacted into law. One option the IRS could pursue, without legislative changes, to somewhat offset these risks involves using manual research techniques to resolve more miscellaneous income and wage statements with mismatched names and identification numbers.

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<sup>8</sup> Internal Revenue Code § 6103 (2007) protects the confidentiality of wage earner identification numbers and does not permit disclosing to employers the actual numbers or whether the numbers match IRS records. However, under Internal Revenue Code § 3406 (2007), such disclosure is generally allowed to businesses and other third parties for payments subject to backup withholding, including payments to independent contractors.

<sup>9</sup> In written Congressional testimony, this Association expressed support for the proposal that would require employers to verify the accuracy of identification numbers of independent contractors they hire, provided the system is user friendly, provides quick responses, and is accessible online or by telephone.

<sup>10</sup> The legislation was introduced in April 2003 to the 108<sup>th</sup> United States Congress, which was in session during 2003 and 2004.



## ***Mismatched Names and Identification Numbers on Information Documents Could Undermine Strategies for Reducing the Tax Gap***

### **The IRS needs to use manual research techniques to resolve more mismatched names and identification numbers on miscellaneous income and wage statements**

When the IRS is unable to resolve mismatched name and identification number combinations on wage and miscellaneous income statements in any given year, the statements and related earnings are placed in mismatch files. Each file represents the total amount of statements obtained in a given year for which the IRS did not have matching names and identification numbers in its records. 2(e), 2(f)

For TY 2004, the most recent year for which the IRS had complete data, approximately 11.8 million records involving wages and miscellaneous income of almost \$206 billion were placed in a mismatch file. The vast majority (about 75 percent) of the wage statements reported earnings of \$10,000 or less, and roughly one-half of the total wage statements reported withholding taxes. Therefore, even if the wages were not reported on any tax returns, some tax revenues were likely collected from the earnings. While not unexpected, only 1 percent of the miscellaneous income statements reported any withholding taxes.

To estimate the number of people that may not have filed tax returns or reported their incomes by using incorrect identification numbers, we used IRS automated data systems to manually research statistically valid samples of 374 miscellaneous income statements and 246 wage statements from TY 2004 that were in the mismatch file reporting more than \$60,000 in earnings.<sup>11</sup> We successfully validated 309 (50 percent) of the 620 statements and matched them to taxpayer accounts in IRS records.

As summarized in Figure 3, our sample results, when projected to the populations of miscellaneous income and wage statements in the mismatch file reporting more than \$60,000 in earnings, indicate 6,042 individuals had not filed TY 2004 returns, although the mismatched documents reported they had earned, on average, about \$104,327 or \$630 million in total. Some individuals had not filed tax returns for several years, and the mismatched documents showed their earnings exceeded \$200,000 in 1 or more years. Altogether, we estimate the 6,042 individuals who may not have filed their tax returns could owe \$233.36 million in taxes, interest, and penalties on the \$630 million of earnings.<sup>12</sup>

<sup>11</sup> We selected statements reporting more than \$60,000 in earnings because it would enable us to focus our efforts on those with the highest amount of unreported income.

<sup>12</sup> See Appendix IV for details.





**Mismatched Names and Identification Numbers on Information Documents Could Undermine Strategies for Reducing the Tax Gap**

**Figure 3: TY 2004 Miscellaneous Income and Wage Statements Reporting More Than \$60,000 With Mismatched Names and Identification Numbers**

Characteristics	Wage Statements	Miscellaneous Income Statements	Totals
Total number of statements in the IRS file	6,339	97,132	103,471
Total amount of earnings reflected on the statements	\$681 million	\$124 billion	\$125 billion
Estimated number of nonfilers	593	5,449	6,042
Estimated earnings associated with the nonfilers	\$54 million	\$576 million	\$630 million

Source: The IRS mismatch file and our sample. Dollars in Figure 3 are approximate.

Without further IRS investigation, we do not know whether taxes are owed on the estimated \$630 million in earnings associated with the mismatched documents or whether the related tax returns are required to be filed. However, we do know that, 2(e), 2(f)

Approximately 39 percent of the individuals included in our samples are the subjects of ongoing IRS nonfiler investigations.<sup>13</sup> However, officials from the IRS Office of Filing Compliance in the Small Business/Self-Employed Division told us that, 2(e), 2(f)

Although our results indicate the mismatch file can provide a good source for identifying individuals who do not file tax returns that may otherwise go undetected, use of this technique will require reallocating some IRS resources. This could partially offset the benefit of the increased revenue identified by resolving the mismatched documents because other IRS investigations may not be conducted. However, we believe this impact can be minimized by focusing on only the statements with the highest amounts of potential unreported income. In

<sup>13</sup> We manually researched statistically valid samples of 374 miscellaneous income statements and 246 wage statements from TY 2004 that were in the mismatch file reporting more than \$60,000 in earnings and identified 44 nonfilers. We determined 17 (39 percent) of the 44 nonfilers were under IRS investigation.



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## *Mismatched Names and Identification Numbers on Information Documents Could Undermine Strategies for Reducing the Tax Gap*

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deciding whether to use the mismatch file, it is important to consider that nearly all (97 percent) of the miscellaneous income statements in the file involve earnings of \$60,000 or less, while the remaining 3 percent (those with more than \$60,000) account for the vast majority (about 83 percent) of the earnings.

### ***Recommendations***

The Director, Examination, Small Business/Self-Employed Division, should:

**Recommendation 1:** Forward the observations in this report to the Department of the Treasury to use in assessing the need for tax law changes that would allow the IRS to verify employee identification numbers for employers and require employers to (1) use the IRS identification number matching system to verify the accuracy of identification numbers for the employees they hire and (2), for tax administration purposes, withhold taxes at the maximum rates on those whose identification numbers do not match IRS records.

**Management's Response:** IRS management agreed with this recommendation and will forward a copy of the report to the Department of the Treasury Office of Tax Policy.

**Recommendation 2:** Use the IRS automated data systems to research, resolve, and investigate high-dollar miscellaneous income and wage statements with mismatched names and identification numbers.

**Management's Response:** The IRS did not agree to take action on this recommendation. In deciding to not take action, the IRS noted the additional cost of manually perfecting mismatched documents may exceed the monetary benefits.

**Office of Audit Comment:** The IRS decision not to act on our recommendation based on a cost/benefit concern is puzzling because no exceptions were taken to how we determined the benefit of \$233.36 million in additional revenue, which we estimate exceeds by a large margin the costs the IRS would incur. In Fiscal Year 2007, for example, the IRS paid its most experienced examiners working in the highest cost of living area in the country about \$62 an hour in salary and benefits. IRS records show the examiners produced about \$354 for each hour they spent examining a tax return (a net return of about \$292 an hour). In comparison, we estimate that, if instead of examining tax returns the examiners had perfected and investigated the 103,471 mismatched documents reflected in Figure 3 of the report, they would have generated an average of about \$2,255 an hour (a net return of about \$2,193 an hour).



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*Mismatched Names and Identification Numbers on Information Documents Could Undermine Strategies for Reducing the Tax Gap*

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## **Appendix I**

### *Detailed Objective, Scope, and Methodology*

The overall objective of this review was to evaluate the progress of efforts to minimize the volume of mismatched names and identification numbers reported on the Miscellaneous Income (Form 1099-MISC) and the Wage and Tax Statement (Form W-2) (hereafter referred to as miscellaneous income and wage statements, respectively). During the review, we relied on databases provided to us by the IRS. We did not conduct audit tests to determine the accuracy and reliability of the information in any of the databases. However, we did assess the reasonableness of the data as described below and concluded the data were reliable and adequate to conduct our work. Also, we did not evaluate the adequacy of IRS internal controls over miscellaneous income and wage statements because that was outside the scope of the review. To accomplish our objective, we:

- I. Reviewed a significant amount of material to gain an understanding of and the need for reducing the number of miscellaneous income and wage statements with mismatched names and identification numbers. The sources included the President's Fiscal Year 2008 budget submission to Congress, the Department of the Treasury strategy for reducing the tax gap,<sup>1</sup> and numerous reports issued by the IRS, the GAO, and us on the subject.
- II. Reviewed IRS guidelines and interviewed its personnel to learn how miscellaneous income and wage statements are processed, validated, and perfected.
- III. Analyzed extracts from the IRS records of miscellaneous income and wage statements submitted with mismatched names and identification numbers for TYs 2001 through 2004 to identify filing trends and characteristics.
- IV. Tested the reasonableness of the information from our extracts of IRS records by comparing it to written testimony submitted to Congress by the IRS.
- V. Reviewed the Internal Revenue Code<sup>2</sup> to identify the tax laws applicable to information reporting.
- VI. Analyzed a statistically valid attribute sample of 246 of the 6,339 wage statements contained in the IRS' records of mismatched names and identification numbers that were

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<sup>1</sup> The difference between what is paid in taxes and what should be paid according to the tax laws.

<sup>2</sup> 26 U.S.C. Section 3406 (2006).



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submitted in TY 2004 and reported more than \$60,000 in earnings,<sup>3</sup> to determine if the mismatches could be resolved and used to identify unreported income and/or nonfiling situations. The sample was based on a 95 percent confidence level, a nonfiling occurrence rate of 9.35 percent, and a precision rate of  $\pm 3.64$  percent. The nonfiling occurrence rate was determined by dividing the 23 nonfilers identified in our sample by the 246 wage statements.

- VII. Analyzed a statistically valid attribute sample of 374 of the 97,132 miscellaneous income statements contained in the IRS' records of mismatched names and identification numbers that were submitted in TY 2004 and reported more than \$60,000 in earnings, to determine if the mismatches could be resolved and used to identify unreported income and/or nonfiling situations. The sample was based on a 95 percent confidence level, a nonfiling occurrence rate of 5.61 percent, and a precision rate of  $\pm 2.3$  percent. The nonfiling occurrence rate was determined by dividing the 21 nonfilers identified in our sample by the 374 miscellaneous income statements.
- VIII. Used variable sampling techniques based on the nonfiling occurrence rates to estimate the dollar amount of earnings for the population of mismatched miscellaneous income and wage statements that may have gone unreported because the taxpayers did not voluntarily file their income tax returns.
- IX. Confirmed the accuracy and validity of our projections with statisticians from the IRS Statistics of Income Division.

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<sup>3</sup> We selected statements reporting more than \$60,000 in earnings because it would enable us to focus our efforts on those with the highest amount of unreported income.



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## **Appendix II**

### *Major Contributors to This Report*

Daniel R. Devlin, Assistant Inspector General for Audit (Small Business and Corporate Programs)  
Philip Shropshire, Director  
Frank Dunleavy, Audit Manager  
William Tran, Lead Auditor  
Earl Charles Burney, Senior Auditor  
Timothy Greiner, Senior Auditor  
Stanley Pinkston, Senior Auditor  
James Adkinson, Information Technology Specialist  
Martha Stewart, Information Technology Specialist



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**Appendix III**

*Report Distribution List*

Acting Commissioner C  
Office of the Commissioner – Attn: Acting Chief of Staff C  
Deputy Commissioner for Services and Enforcement SE  
Deputy Commissioner, Small Business/Self-Employed Division SE:S  
Director, Examination, Small Business/Self-Employed Division SE:S:E  
Chief Counsel CC  
National Taxpayer Advocate TA  
Director, Office of Legislative Affairs CL:LA  
Director, Office of Program Evaluation and Risk Analysis RAS:O  
Office of Internal Control OS:CFO:CPIC:IC  
Audit Liaison: Commissioner, Small Business/Self-Employed Division SE:S



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## **Appendix IV**

### *Outcome Measure*

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. This benefit will be incorporated into our Semiannual Report to Congress.

#### **Type and Value of Outcome Measure:**

- Increased Revenue – Potential; \$233.36 million per year; \$1.17 billion over 5 years. This represents the additional revenue associated with taxes, interest, and penalties on assessments from researching, resolving, and investigating the Miscellaneous Income (Form 1099-MISC) and the Wage and Tax Statements (Form W-2) (hereafter referred to as miscellaneous income and wage statements, respectively) with mismatched names and identification numbers reporting more than \$60,000 in earnings.<sup>1</sup> The value of the outcome measure does not include amounts (costs) that could partially offset this benefit due to reallocating some resources from other IRS investigations (see page 6).

#### **Methodology Used to Measure the Reported Benefit:**

To estimate the potential additional revenue associated with researching, resolving, and investigating miscellaneous income and wage statements with mismatched names and identification numbers, we:

1. Analyzed statistically valid samples of 374 miscellaneous income statements and 246 wage statements with mismatched names and identification numbers reporting more than \$60,000 in earnings, to determine the number of documents that could be manually perfected and identified without income tax returns. Our samples were selected from populations of 6,339 wage statements and 97,132 miscellaneous income statements submitted for TY 2004.
2. Used the results of our samples to project that mismatched documents for 5,449 miscellaneous income statements and 593 wage statements could not be associated with income tax returns filed reporting the income.
3. Shared our methodology for projecting our attribute and variable samples into the populations of mismatched miscellaneous income and wage statements with IRS

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<sup>1</sup> We selected statements reporting more than \$60,000 in earnings because it would enable us to focus our efforts on those with the highest amount of unreported income.



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Statistics of Income Division staff, who confirmed the accuracy and validity of the projections.

4. Followed the IRS Substitute for Return program procedures<sup>2</sup> for preparing proposed assessments. Our calculations of taxes, interest, and penalties were based on these procedures, along with our assumptions that (1) there were no expenses associated with the miscellaneous income statements, (2) the individual's filing status was Single, and (3) there were no other sources of income for the taxpayer.
5. Applied and calculated the applicable Federal income tax rates to the 5,449 miscellaneous income statements and the 593 wage statements. In addition, we applied the appropriate self-employment tax rates and adjustments to the earnings reported on the miscellaneous income statements.
6. Used the IRS' internal computer programs to apply the penalty for failure to file, the penalty for failure to pay, and interest from April 15, 2005 (due date of the return), to December 31, 2006.

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<sup>2</sup> The IRS prepares a substitute for return when a taxpayer appears to have a filing requirement but does not comply by voluntarily filing a tax return.






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**Appendix V**

*Management's Response to the Draft Report*

	<b>DEPARTMENT OF THE TREASURY</b> INTERNAL REVENUE SERVICE WASHINGTON, D.C. 20224	<b>'RECEIVED</b>  AUG - 8 2007
DEPUTY COMMISSIONER		
August 8, 2007		
MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT		
FROM:	Kevin M. Brown <i>KMB</i> Deputy Commissioner for Services and Enforcement	
SUBJECT:	Draft Audit Report – Mismatched Names and Identification Numbers on Information Documents Could Undermine Strategies for Reducing the Tax Gap (Audit #200630IE002)	
<p>We have reviewed your draft report and agree that accurate information reporting allows the IRS to more economically and efficiently detect and pursue noncompliant taxpayers. To this end, the Internal Revenue Service (IRS) and Social Security Administration (SSA) have established rigorous systemic procedures to perfect and validate Social Security Numbers (SSNs) shown on information documents.</p> <p>As noted in your report, the majority of the information documents with mismatched names and identification numbers involved nonemployee miscellaneous income statements. We have worked with Treasury to recommend legislation that would require payors to verify the accuracy of identification numbers for independent contractors and subject those not in compliance to backup withholding procedures. Our backup withholding program notifies payors of those payees with mismatched numbers in order to encourage voluntary reporting and ensure adequate withholding.</p> <p>While we agree that additional tax law changes could improve the accuracy of identification numbers, certain changes should be approached with caution, especially with respect to the sharing of information. We have an ongoing relationship with the SSA and endeavor to keep abreast of their actions related to SSN and name mismatches on Forms W-2. However, as your report states, the IRS is precluded from the mutual sharing of taxpayer data, except in certain statutorily defined circumstances pursuant to Internal Revenue Code (IRC) section 6103. Taxpayers are aware under current statutes that the sharing of information with the IRS ensures a measure of confidentiality. We need to ensure that any legislative change to IRC section 6103 still provides an adequate level of confidentiality to support sound tax administration.</p>		



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In this report, you recommend manual perfection of miscellaneous income and wage statements. Due to the vigorous systemic perfection already performed on these documents, the cost of an additional labor intensive process may not outweigh the monetary benefits. For example, the sample in your report resulted in perfection of only half of the documents reviewed. From that subset, only a portion would represent taxpayers who did not file a return or have not been identified through our existing compliance programs. In addition, the income tax owed may not be substantial after factoring in the fact that wage earners would have income tax withholding and miscellaneous income earners may have potentially deductible expenses associated with the earnings. Based on the reasons stated as well as competing priorities, we do not plan to dedicate resources to manual perfection.

Attached is a detailed response to your recommendations. If you have any questions, please call Kathy Petronchak, Commissioner, Small Business/Self-Employed Division (SB/SE) at (202) 622-0600 or Sherri Brown, Director Examination Policy, SB/SE, at (202) 283-2070.

Attachment



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*Mismatched Names and Identification Numbers on Information Documents Could Undermine Strategies for Reducing the Tax Gap*

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**Attachment**

**RECOMMENDATION 1:**

The Director, Examination, Small Business/Self-Employed Division, should forward the observations in this report to the Department of the Treasury to use in assessing needed tax law changes that would allow the IRS to verify employee identification numbers for employers and require employers to (1) use the IRS identification number matching system to verify the accuracy of identification numbers for the employees they hire and (2), for tax administration purposes, withhold taxes at the maximum rates on those whose identification numbers do not match IRS records.

**CORRECTIVE ACTIONS:**

We agree with your recommendation. Upon receipt of the final report, the Director Communications, Liaison and Disclosure will forward a copy to Treasury Tax Policy.

**IMPLEMENTATION DATE:**

October 15, 2007

**RESPONSIBLE OFFICIAL:**

The Director, Communications, Liaison and Disclosure, Small Business/Self-Employed Division

**CORRECTIVE ACTION(S) MONITORING PLAN:**

The Director, Communications, Liaison and Disclosure, Small Business/Self-Employed Division will notify the Director, Legislative Affairs once the report is shared with Treasury.

**RECOMMENDATION 2:**

The Director, Examination, Small Business/Self-Employed Division, should use the IRS automated data systems to research, resolve, and investigate high-dollar miscellaneous income and wage statements with mismatched names and identification numbers.

**CORRECTIVE ACTIONS:**

While the manual perfection of the mismatch file might enhance or create some additional cases to what is already identified through systemic methods, the cost of an additional labor intensive process may not outweigh the monetary benefits. For example, the sample in the report resulted in perfection of only half of the documents reviewed and only a portion represented taxpayers who had not filed a return or been identified through existing compliance programs. In addition, the income tax owed may not be substantial after factoring in income tax withholding for wage earners and deductible expenses associated with the miscellaneous income earners. Based on the reasons stated as well as competing priorities, we do not plan to dedicate resources to manual perfection.



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*Mismatched Names and Identification Numbers on Information Documents Could Undermine Strategies for Reducing the Tax Gap*

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**IMPLEMENTATION DATE:**

N/A

**RESPONSIBLE OFFICIAL:**

N/A

**CORRECTIVE ACTION(S) MONITORING PLAN:**

N/A